

WISCONSIN OUTLOOK

The outlook continues to be positive for employment and personal income growth in the State over the next several years. While short term projections have been revised down slightly, they remain positive. Also, the Wisconsin economy will be less cyclical than the nation's by avoiding both the immediate loss associated with the hurricanes and the additional spending associated with the recovery.

On the employment front, rising energy costs, a strengthening dollar over the past year, and continued strong productivity growth have slightly weakened the forecast for Wisconsin employment growth in the near term. Three months ago the outlook for employment growth this year was pegged at 0.9%; we have lowered the employment growth projection for the current forecast to 0.8% due to weaker than expected employment growth over the past several months.

Manufacturing employment growth is likely to remain problematic in the face of high energy costs, a strong dollar, increasing productivity, and continued global competition. This is especially true for Wisconsin and other Midwest states. A recent study of energy markets and the Midwest economy¹ suggests that the Midwest region (defined as the Chicago Federal Reserve states of Illinois, Indiana, Iowa, Michigan, and Wisconsin) may feel the effects of rising energy prices slightly more than the nation as a whole because the region has increased its share of energy intensive industries. In addition, the region is highly reliant on natural gas, so volatility and price increases in this fuel should bear our particular attention. The study also singled out Indiana and Wisconsin as states that may be more significantly impacted by higher fuel prices.

Over the longer term, expectations for employment growth over the next five years have been lowered due to persistently weak manufacturing employment growth. Total employment growth should remain positive with annual rates of 0.9% to 1.4% expected over the next four years.

The outlook continues to be encouraging for living standards of Wisconsin residents based on personal income growth. Growth in Wisconsin personal income is expected to average 5.1% this year and 5.7% next year. In the short term, a combination of downwardly revised income growth over the past three years, slightly lowered expectations for employment growth, and higher inflation has also resulted in a lower forecast for total inflation-adjusted personal income growth this year (2.3%) relative to three months ago (3.3%). However, the longer term expectations for income growth are little changed from three months ago, ranging from 3.1% to 3.9% (inflation adjusted) over the next four years. On average, real per capita income growth in Wisconsin is expected to exceed real per capita income growth in the nation by about 0.19% annually from 2007 to 2010.

Recent Evidence

In the third quarter of 2005, five industries posted employment gains over the second quarter, six posted declines, and one showed no change in employment. The industries that added employment were Financial Activities (+300), Professional and Business Services (+4,300), Leisure and Hospitality Services (+2,200), Other Services (+2,000), and State and Local Government (+1,700). Industries with employment declines were Natural Resources and Mining (-200), Construction (-1,200), Manufacturing (-1,100), Information (-1,000), Education and Health Services (-500), and Federal Government (-200). Employment in Trade, Transportation, and Utilities was unchanged. Total Private employment advanced by 4,700, and total nonfarm employment advanced by 6,300.

¹ Energy Markets and the Midwest Economy, Richard H. Mattoon, *Economic Perspectives*, 4Q/2005, Federal Reserve Bank of Chicago.

Overall, recent monthly data from the Bureau of Labor Statistics indicates that earlier forecasts of employment may have been slightly too high, resulting in a downward revision to our employment growth projection for 2005. First, the initial annualized employment growth in the second quarter was revised from 1.6% to 1.4%. Second, the forecasted employment growth of 1.3% for the third quarter proved to be too optimistic as the actual growth came in at 0.9%. Manufacturing employment growth continues to disappoint with negative numbers, knocking 0.2 percentage points from employment growth projections of the August forecast.

The latest estimates for Wisconsin personal income were released by the U.S. Department of Commerce, Bureau of Economic Analysis (BEA) on September 28, 2005. The data release presented preliminary estimates for the second quarter of this year along with revisions to prior estimates for all quarters and years going back to 2002.

On net the revisions were small. Total personal income was revised up in 2002 by an average of 0.25% per quarter and down in 2003 and 2004 by nearly 0.30% per quarter. The first quarter was revised down by 0.875% or \$1.6 billion. This was not unexpected because previous estimates for wages and salaries were singled out as being too high, and indeed, wages and salaries were revised down in the first quarter.

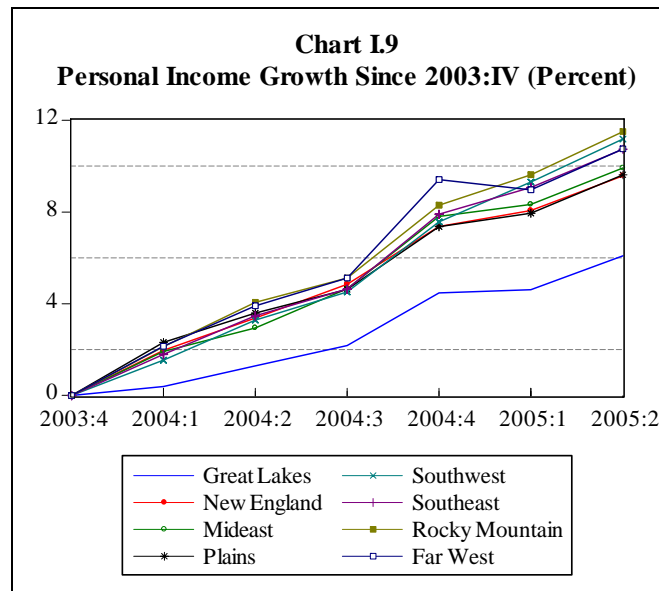
Other notable revisions were made to several components of total personal income. The residence adjustment was revised down by nearly 3%; this means that cross-border job commuting from Wisconsin to Illinois and Minnesota is not as prevalent as previously thought. Nonfarm proprietors' income was revised down by significant amounts (in the range of \$1.3 to \$1.8 billion, or 12%-13% over three years) and property income, made up of dividends, interest, and rental income, was revised up by an average of \$0.475 billion per quarter over the last 13 quarters.

The average annual growth rate for Wisconsin personal income for the period 2002:1 to 2005:1 was 4.6% prior to the revisions; after revisions it is now 4.1%. The first estimates of total personal income in the second quarter show an annualized growth rate of 5.5%, and annualized wage and salary growth of 4.8%. On a year-over-year basis, total personal income grew 5.9% in the second quarter; wages and salaries grew by 6.4%.

In the BEA news release, the following paragraph was notable for the attention drawn to the Great Lakes Region and to Wisconsin. The Great Lakes Region, composed of the states of Illinois, Indiana, Michigan, Ohio, and Wisconsin, is one of eight BEA regions of the U.S. used for reporting and analyzing economic conditions. (The BEA Great Lakes Region differs from the Chicago Fed region.)

"For the last year and a half the Great Lakes region has persisted on a distinctly slower personal income growth trajectory than the rest of the country. Even the strongest state within the Great Lakes, Wisconsin, is growing slower than the Plains regional average (the Plains being the second weakest region). Since the fourth quarter of 2003 earnings by place of work has grown only 6.3 percent in the Great Lakes versus 11.8 percent in the rest of the country, largely because of weakness in the region's durable goods manufacturing industry."

The paragraph was accompanied by the following chart:

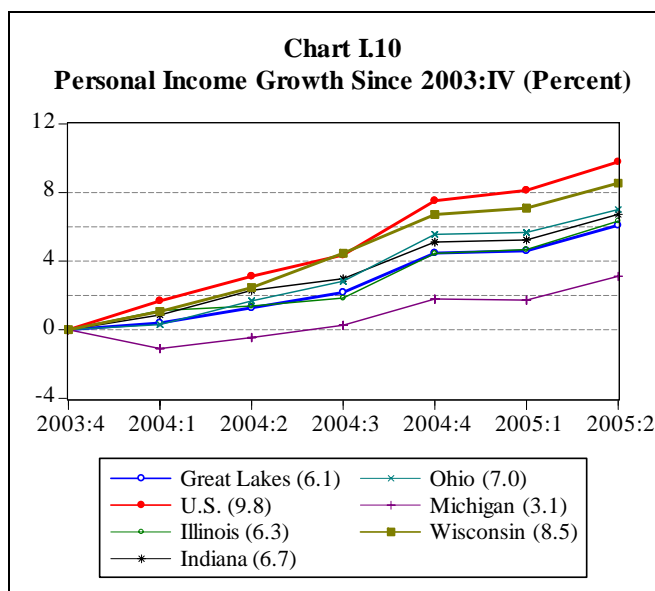


There is more to the story, however. When we compare personal income growth in Wisconsin with each of the states in the Great Lakes Region, we can note, as BEA stated, that Wisconsin has the strongest growth of the five states. Wisconsin, however, with a cumulative growth of 8.5% over six quarters, is closer to the U.S. cumulative growth of 9.8%, than it is to the Great Lakes Region cumulative growth of 6.1%. Note that BEA speaks of growth in earnings, but charts personal income growth.

Chart I.10 is a modification of the BEA chart, showing personal income growth for the U.S., the Great Lakes Region, and the five states in the region. There are two new perspectives from this chart.

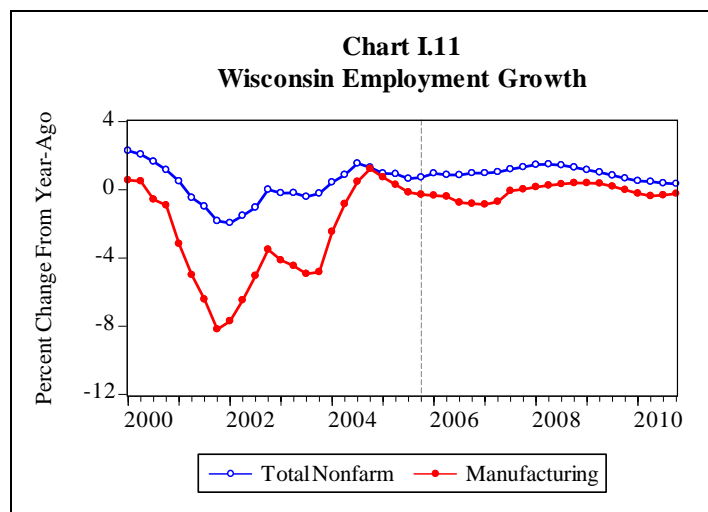
First, Wisconsin and Michigan are the outliers in regional growth rates. Wisconsin is growing more strongly while Michigan is growing weakly. Illinois, Indiana, and Ohio are bunched closely together when measured by personal income growth. Michigan, because of its size (over 21% of regional income) can more easily affect the regional average than can Wisconsin (under 12% of regional income).

Second, personal income growth in Wisconsin was closer to the U.S. average for the period 2003:4 to 2004:4. It is only during the last two quarters that Wisconsin's income growth has noticeably slowed relative to U.S. income growth. The last two quarters are also subject to future revisions as new data becomes available to BEA, probably more so than the previous quarters.



Employment Outlook

The forecast calls for employment growth of 0.7% (annual rate) in the fourth quarter. Employment growth at rates at or below 1% should continue through next year. Total nonfarm employment is expected to advance by 0.8% in 2005 and by 0.9% in 2006. As energy prices stabilize and drift lower, and as the dollar falls as assumed in the national forecast, employment growth in Wisconsin should pick up to 1.1% in 2007, and 1.4% in 2008. The average annual rate of employment growth for the years 2006 through 2010 is expected to be 0.9%.



By industry, the forecast projects that virtually all of the employment growth will occur in the service producing sector. In the goods-producing sector, manufacturing employment faces strong headwinds in the form of competition from cheaper foreign labor, the substitution of capital for labor underlying the strong productivity growth trend, and rising energy prices. Construction employment is also likely to see little growth, as the housing boom fades in response to higher interest rates. Manufacturing employment is projected to grow by 0.1% in 2005, and to decline by 0.6% in 2006, followed by another decline of 0.1% in 2007. Goods-producing industries (mining, manufacturing, and construction) are expected to decline by an annual average of 0.1% from 2006 to 2010. Construction employment will likely grow 4.2% this year, and then decline by 0.6% in 2006 and 0.1% in 2007.

In the service sector, the fastest growth is expected in Education and Health Services employment, where annual growth is forecast to average 2.0% this year. Education and Health Services employment is expected to post average annual growth of 2.7% from 2006 to 2010, compared to 1.2% per year for all service industries combined. Health service employment will benefit from both demographically driven demand and expanding technological opportunities.

Employment in Professional and Business Services is also expected to experience above average growth, despite the apparent weakness in the first quarter of this year, when employment contracted by 5.5% (annual rate). Business and Professional Services employment is expected to expand by 1.3% in 2005 and by 2.7% in 2006. Leisure and Hospitality Services employment, after having advanced by more than 2.0% in 2003 and 2004, will slow to 1.5% this year, and to growth rates averaging 1.1% in the future in response to demographics and higher energy prices.

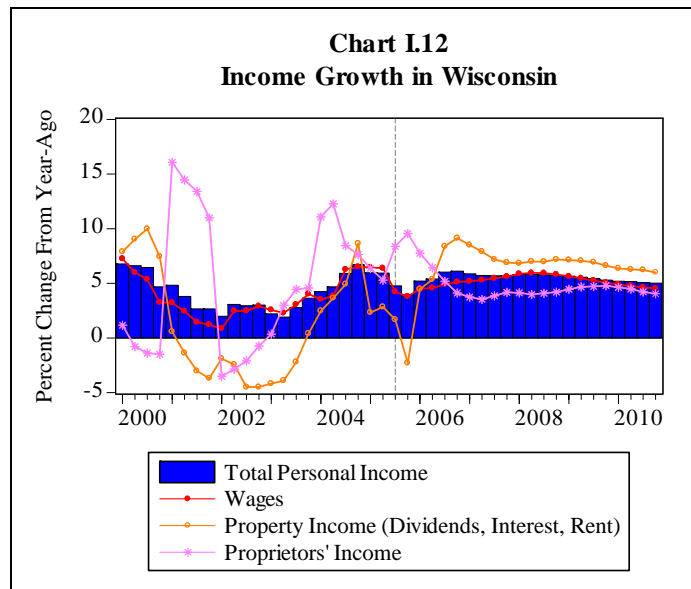
Details of the Wisconsin employment forecast are presented in Appendices 2 and 3.

Income Outlook

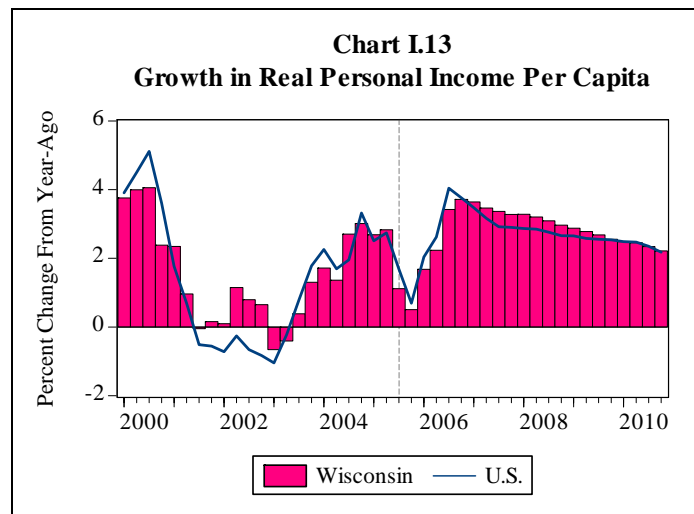
Growth in Wisconsin personal income surged in the last two quarters of 2004. In the third quarter, total personal income grew at an 8.1 % annualized rate, powered by a surge in wage income which increased at a 12.6% rate. In the fourth quarter, total personal income grew at an even faster 8.9% annualized rate. In that quarter the strength was concentrated in property income which increased at a 23.3% annual rate. Information from 2004 individual income tax returns confirms that income did indeed surge in 2004, with Wisconsin adjusted gross income (AGI) growing by 5.7%, the best performance since 2000, when AGI grew by 6.7%.

Estimates of income in the first and second quarter indicate a deceleration in income growth, due in large measure to the "loss" of the \$1.1 billion from the one-time Microsoft dividend. Year-over-year growth was still strong however, 6.0% and 5.9% in the first and second quarter, respectively, compared to 5.9% and 6.7% in the third and fourth quarters of 2004. Growth in wage and salary income in the second quarter 2005 was estimated to be 4.8%.

Growth in Wisconsin personal income is expected to average 5.1% this year and 5.7% next year. Wage and salary income is expected to grow by 5.2% in 2005 and by 4.8% in 2006 in response to weaker employment growth. In the longer term, Wisconsin personal income is expected to average 5.5% annually from 2006 to 2010. Proprietors' income is expected to grow by 7.4% this year after growing by 9.8% in 2004. Proprietors' income will advance by 5.8% in 2006. Property income (dividends, interest, and rent) will grow by 1.1% this year and by 6.9% in 2006 after growth of 4.9% in 2004. Average annual growth of property income from 2006 to 2010 is expected to be 7.0%.



The forecast remains a positive one for living standards of Wisconsin residents. Nominal income growth above 5% will translate into real income growth above 3% given the 2% forecast of inflation (as measured by the NIPA chain weighted price index for consumer purchases). On a per capita basis, real income is forecast to increase by 1.8% this year and by 2.8% in 2006. On average, real per capita income growth in Wisconsin is expected to exceed real per capita income growth in the nation by about 0.19% annually from 2007 to 2010, after having lost ground from 2003 to 2006. As noted in Chart I.13, per capita income growth in Wisconsin is projected to lag the nation in 2006, but surpass the nation in 2007 and 2008.



Details of the Wisconsin income forecast are presented in Appendices 4 and 5.